A Report to the Montana Legislature

Financial-Compliance Audit

Montana State Fund

For the Two Fiscal Years Ended June 30, 2012

December 2012

Legislative Audit Division

12-05A

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§5-13-202(2), MCA

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Financial-Compliance Audits

Financial-compliance audits are conducted by the Legislative Audit Division to determine whether an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2011, was issued March 29, 2012. The Single Audit Report for the two fiscal years ended June 30, 2013, will be issued by March 31, 2014. Copies of the Single Audit Report can be obtained by contacting:

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Office of Budget and Program Planning
Room 277, State Capitol
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Cindy Jorgenson
Angus Maciver

December 2012

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report of the Montana State Fund, a component unit of the state of Montana, for the two fiscal years ended June 30, 2012. The statements include comparative information for the fiscal year-ended June 30, 2011. This report contains one recommendation related to recording estimated claims liabilities on the state's accounting records. On page A-1, you will find the Independent Auditor's Report. We issued an unqualified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund's response to our audit is on page B-1. We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
Legislative Auditor

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Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard, President/CEO	
	Mark Barry, Vice President, Corporate Support	
	Richard Duane, Vice President, Human Resources	
	Richard Root, Vice President, Insurance Operations	
	Peter Strauss, Vice President, Insurance Operations Support	
	Nancy Butler, General Counsel	
	Al Parisian, Chief Information Officer	
State Fund Board of Directors		Term Expires
	Elizabeth Best, Chair	2015
	Joe Brenneman	2015
	Jane Debruycker	2013
	Wayne Dykstra	2015
	Thomas R. Heisler	2013
	Ken Johnson	2013
	James Swanson	2013

For additional information concerning the Montana State Fund contact:

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Montana Legislative Audit Division

Financial-Compliance Audit
Montana State Fund
For the Two Fiscal Years Ended June 30, 2012

December 2012 | 12-05A | Report Summary

As a result of worker's compensation legislation passed in 2011, Montana State Fund (MSF) implemented an overall 20 percent rate decrease in fiscal year 2011-12. As a result, MSF's Net Earned Premium decreased approximately 13.3 percent from $173.6 million in fiscal year 2010-11 to $150.5 million in fiscal year 2011-12. The long-term impact of this legislation on worker's compensation claims will not be known for several years.

Context

MSF is administratively attached to the state of Montana, Department of Administration. MSF is governed by a seven member board of directors appointed by the Governor. The MSF is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated, and provides Montana employers with an option for workers' compensation and occupational disease insurance, guaranteeing available coverage for all employees in Montana.

In fiscal year 2011-12, MSF's net premiums earned were $150.5 million and claims incurred were close to $130 million. Active policies remained about the same for fiscal years 2010-11 and 2011-12. MSF paid $6 million in dividends to policyholders in fiscal year 2011-12.

MSF accounts for claims incurred on or after July 1, 1990 (New Fund) separately from claims incurred prior to July 1, 1990, (Old Fund). By fiscal year-end 2010-11, the Old fund exhausted all of its resources and by state law, the General Fund became responsible for paying the claims. In fiscal year 2010-11, a General Fund transfer of $50,000 was made to cover remaining claims for the year. In fiscal year 2011-12, payment of the Old Fund claims and operating costs required a General Fund transfer of $10,041,517. The total Old Fund estimated claims liability at June 30, 2012 was $59,161,706. Because the claims are an obligation of the General Fund, Old Fund liabilities are no longer reflected in the MSF financial statements.

Results

This report contains one recommendation related to recording the current portion of the estimated claims liability on the state's accounting records in accordance with state law.

Recommendation Concurrence	
Concur	1
Partially Concur	0
Do Not Concur	0
Source: Agency audit response included in final report.	

For a complete copy of the report (12-05A) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to lad@mt.gov; or check the web site at http://leg.mt.gov/audit
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Chapter I – Introduction

Introduction

We performed a financial-compliance audit of the Montana State Fund (MSF) for the two fiscal years ended June 30, 2012.

The objectives of this audit were to:

1. Determine whether MSF complied with selected applicable laws and regulations.
2. Obtain an understanding of the MSF's control systems to the extent necessary to support our audit of MSF's financial statements, and if appropriate, make recommendations for improvement in management and internal controls of MSF.
3. Determine whether the MSF's financial statements present fairly the financial position, results of operations, and cash flows for the fiscal year ended June 30, 2012, with comparative financial amounts for the fiscal year ended June 30, 2011.

MSF personnel prepared the financial statements based on accounting information from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustments. Adjustments are made to present financial activity in accordance with generally accepted accounting principles. This report contains one recommendation related to recording the current portion of the estimated claims liability separately from the total liability recorded on SABHRS in accordance with state law and state accounting policy. In accordance with §5-13-307, MCA, we analyzed the costs of implementing this recommendation and do not believe them to be significant. The prior audit contained no recommendations.

Background

Montana State Fund is a nonprofit, independent public corporation that provides Montana employers with an option for workers' compensation and occupational disease insurance, and guarantees available coverage for all employees in Montana. Montana State Fund is governed by a seven-member board of directors appointed by the Governor. State law separates funding sources for claims incurred before July 1, 1990, (Old Fund) and those incurred on or after July 1, 1990, (New Fund).

Montana State Fund management must set premium rates for the New Fund at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain a surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer.

The investments of the Montana State Fund are managed by the Montana Board of Investments and invested according to policies outlined in law.

Prior to fiscal year 2010-11, Old Fund claim costs were funded primarily by investment earnings and investment principal. However, beginning in fiscal year 2010-11, Old Fund assets were insufficient to pay all claims that became due or payable; therefore, as required by law, a state General Fund transfer of $50,000 was necessary to pay the remaining due and payable claims for the year. In fiscal year 2011-12, General Fund payments for Old Fund claims and operating costs totaled to $10,041,517.

Chapter II – Findings and Recommendations

Recording Current Liabilities

Montana State Fund (MSF) is not separately recording the current portion of the total estimated claims liability on the state's accounting records as required by state law and state accounting policy.

Section 17-1-102(4), MCA, requires all state agencies to input all necessary transactions to the accounting system before the accounts are closed at the end of the fiscal year in order to present the receipt, use, and disposition of all money and property for which the agency is accountable in accordance with generally accepted accounting principles. State accounting policy requires the short-term (current) portion of the liability to be recorded on the accounting ledger supporting MSF financial statements within the state's accounting records. MSF estimates and records the claims liability on the Statewide Accounting, Budgeting, and Human Resource System (SABHRS) prior to fiscal year-end. However, MSF records the full amount as a long-term liability rather than recognizing a portion as a current liability on SABHRS. Table 1 shows the reported amounts of current, long-term, and total liabilities.

Table 1
Reported Liabilities

Estimated Claims Liabilities	FY 2011-12	FY 2010-11
Current Claims Liability	$114,004,107	$109,287,428
Long-Term Claims Liability	775,936,467	765,515,456
Total Estimated Claims Liability	**$889,940,574**	**$874,802,884**

Source: Compiled by the Legislative Audit Division from Montana State Fund Financial Statements.

For financial reporting purposes, MSF adjusts the SABHRS balances based on actuarial evaluations not available until after the fiscal year-end. The allocation of the current and long-term portion of these liabilities are approved by the MSF Board of Directors at their September meeting. According to MSF staff, once this amount is approved, information regarding the allocation of the estimated claims liabilities is included in MSF's financial statements and is also sent to the Department of Administration's State Accounting Division for preparation of the state's basic financial statements. MSF staff have indicated they did not believe it was necessary to record the current portion of the liability on SABHRS prior to fiscal year-end because the adjusting entries are completed to distinguish the current and long-term portions of the liabilities based on estimates from the independent consulting actuary and are correctly presented in the MSF financial statements. However, MSF's current practice is not in compliance with state law or state accounting policy. An estimate based on past history can be recorded prior to fiscal year-end.

Recommendation #1

We recommend Montana State Fund record the estimated current and long-term claims liabilities on SABHRS prior to the end of the fiscal year-end closing period in accordance with state law and state accounting policy.

Independent Auditor's Report and Montana State Fund Financial Statements

LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Angus Maciver

Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statement of Net Assets of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2012, and 2011, and the related Statement of Revenues, Expenses, and Changes in Fund Net Assets, and Statement of Cash Flows, for each of the fiscal years then ended. The information contained in these financial statements is the responsibility of Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of June 30, 2012, and 2011, and the respective results of operations and cash flows for each of the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America require that the Management Discussion and Analysis beginning on page A-3 and the Schedule of Funding Progress and Risk Management Trend Information beginning on page A-32 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic

financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA
Deputy Legislative Auditor

October 11, 2012

Montana State Fund
(A Component Unit of the State of Montana)
Management Discussion and Analysis
June 30, 2012, 2011 and 2010

Montana State Fund (MSF) is a self-sufficient, not-for-profit workers' compensation insurance carrier. Our statutory purpose is to act as a competitive insurance carrier, providing an available market and thereby guaranteeing coverage to all employers in Montana. MSF operates on the premium dollars paid by insured employers and investment income, and is not funded by the state general fund for primary business operations. We function like a private insurance carrier in a competitive marketplace and, as provided by law, perform all the functions and exercise all the powers of a private insurance carrier that are necessary, appropriate or convenient for the administration of the Montana State Fund.

MSF has undergone a number of changes since our creation in 1990. We have transitioned from a traditional organizational structure to one that is more adapted to the demands of the information age. A comprehensive corporate redesign in 2000 enhanced our operational flexibility with the addition of multifunctional teams that are aligned with specific groups of employers. This change increased employee empowerment and allows us to work more closely with our policyholders and their injured employees. We continue to strive to improve efficiencies in all operational areas and have made a major investment in our safety management services as we work diligently with Montana employers in developing accident prevention programs. MSF has invested more resources for medical management staff and provider relations to improve our focus on managing medical benefit costs, which are about 70% of total claim costs. As our state's economic structure continues to evolve, we stand ready to fulfill our critical role as the guaranteed workers' compensation market for all Montana employers.

Overview of the Financial Statements

This overview is an introduction to Montana State Fund financial statements. The financial statements consist of two components: (1) basic financial statements, and (2) notes to the basic financial statements.

The Statement of Net Assets presents information regarding all of MSF's assets and liabilities, with the difference between the two being reported as net assets.

The Statement of Revenues, Expenses, and Changes in Fund Net Assets present the financial results of operations for MSF for the two most recent fiscal years. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods.

The statement of cash flows details the cash used and provided by the various activities of MSF during the fiscal year. However, this statement does not consider unpaid responsibilities which have been established by contract or other underlying events during the fiscal year.

Financial Highlights

Last fiscal year, MSF successfully implemented substantial workers' compensation legislative changes with the enactment of House Bill (HB) 334, a state law that put into place historic changes to the workers' compensation system in Montana. MSF implemented an overall 20% rate decrease and has

added medical staff to improve our claim handling and ensure that the appropriate medical treatment protocols are applied. MSF also added a provider relations resource to facilitate more timely scheduling of doctor appointments and medical treatment for our injured employees.

Analysis of Financial Position and Results of Operations

The following analysis presents three years of comparative condensed financial data for MSF.

Statement of Net Assets (In thousands)
For the periods ending June 30, 2012, 2011 (restated) and 2010

	6/30/2012	6/30/2011 (Restated)	6/30/2010
Assets:			
Cash and STIP	$ 26,137	$ 19,715	$ 28,149
Investments	1,263,070	1,203,149	1,102,416
Security Lending Collateral	149,465	89,190	167,515
Receivables (Net)	62,230	58,105	63,970
Capital Assets (Net)	32,351	34,720	37,719
Other Assets	49,906	42,089	62,626
Total Assets	$ 1,583,159	$ 1,446,968	$ 1,462,395
Liabilities:			
Estimated Claims Payable	$ 889,940	$ 874,803	$ 838,765
Liability for Securities on Loan	149,465	89,190	167,515
Payables	10,885	15,282	19,590
Other Liabilities	120,936	104,134	119,649
Total Liabilities	1,171,226	1,083,409	1,145,519
Net Assets:			
Beginning Net Assets	363,559	316,876	220,990
Adjust to Beginning Net Assets (Restated)		(4,998)	
Change in Net Assets	48,374	51,681	95,886
Total Net Assets (As Restated)	411,933	363,559	316,876
Total Liabilities and Net Assets	$ 1,583,159	$ 1,446,968	$ 1,462,395

MSF has seen a continual increase in Net Assets the past three years. Net Assets increased approximately 13% or $48.4M (million) from $363.6M (restated) in fiscal year 2011 to $411.9M in fiscal year 2012. Net Assets increased by $46.7M in fiscal year 2011 and $95.9M in fiscal year 2010.

MSF restated fiscal year 2011 to correct the reinsurance funds withheld asset balance in the Statement of Net Assets and the contingent commission (contractual services expense) in the Statement of Revenues, Expenses, and Changes in Fund Net Assets. The fiscal year 2011 beginning Net Assets decreased from

$316.9M to $311.9M (restated), from recording $5.0M directly to equity for the prior years' portion. There was also a contingent commission expense adjustment that increased Operating Expenses by $2.0M. (Refer to Note 1 – Restatement of Prior Year for additional information).

MSF investments include bond and equity holdings and the combined value as of June 30, 2012 was $1.3B, this was an increase of $59.9M or approximately 5% in fiscal year 2012. Investments increased 9% or $100.7M in fiscal year 2011, and 10% or $109.2M in fiscal year 2010 compared to the previous year.

The changes in market value of MSF's investment portfolio of fixed and equity securities in fiscal years 2012, 2011 and 2010 are as follows (In thousands):

	2012	2011	2010
Prior Year Market Value	$1,203,149	$1,102,416	$ 993,222
Purchases at Cost	226,513	217,506	219,627
Sales	(196,328)	(154,964)	(186,920)
Net Realized Gains	4,888	6,425	2,183
Net Accretion of Bonds	25	9	345
Unrealized Gain (Loss)	24,824	31,758	73,958
Current Year Market Value	$1,263,070	$1,203,149	$1,102,416

MSF financial statements include $1.1M in land for fiscal years 2012, 2011, and 2010. Buildings (net of depreciation at June 30, 2012, 2011, and 2010 is $26.8M, $27.4M, and $27.8M, respectively. (Note 1-Other Assets in the Notes to the Financial Statements provides additional information.)

Total liabilities increased by $87.8M in fiscal year 2012 primarily due to the recording an additional $60.3M for Securities on Loan, compared to a decrease in liabilities of $62.1M in fiscal year 2011. This decrease is also primarily due to recording less Securities on Loan of $78.3M. As part of the Board of Investment (BOI) securities lending program, MSF records both an asset and liability in the amount of the cash collateral received. Since an asset and liability are recorded for the same amount, there is no net impact to Net Assets. Fluctuations in this amount are frequent, as the amount recorded depends directly on the amount of securities on loan.

Loss reserves are the actuarially determined estimate of the cost of claims that have already been incurred, and are the most significant liability on MSF's balance sheet. Reserves are decreased as claims are paid and are increased as new losses are incurred.

Loss Adjustment Expense (LAE) reserves represent the loss adjustment, or claim management expenses related to the unpaid losses. Since these amounts are a percentage of unpaid losses, fluctuations are typically similar to fluctuations in unpaid losses.

The Estimated Claims Payable liability is presented undiscounted at $889.9M and $874.8M, net of estimated reinsurance recoverable, as of June 30, 2012, and 2011, respectively. This is an increase of $15.1M compared to fiscal year 2011, and is mostly the result of recording another accident year of losses, prior year development, and $12.4M of reserve strengthening. Management recommended

additional reserve strengthening because of the uncertainty of savings anticipated from HB 334 legislative changes.

The Estimated Claims Payable liability is presented undiscounted, net of an estimated reinsurance recoverable, at $874.8M and $838.8M, as of June 30, 2011 and 2010, respectively. Loss reserves have increased $20.1M since the end of FY10 and the LAE reserves had an increase of $16.0M due to the LAE rate change from 10.8% to 12.4%. This rate change was a recommendation by our external actuaries, Towers Watson.

Towers Watson, an independent actuarial firm, prepares an annual actuarial study used to estimate liabilities, including claim adjustment expenses and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF. Towers Watson provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected a central estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses.

Statement of Revenues, Expenses, and Changes in Fund Net Assets (In thousands) for the fiscal years ending June 30, 2012, 2011, and 2010

	6/30/2012	6/30/2011 (Restated)	6/30/2010
Operating Revenues:			
Net Premium Earned	$ 150,482	$ 173,605	$ 166,265
Total Operating Revenue	150,482	173,605	166,265
Operating Expenses:			
Benefits and Claims	129,664	150,680	153,095
Personal Services	25,245	24,454	22,716
Other Operating Expense	15,821	25,718	13,589
Total Operating Expense	170,730	200,852	189,400
Net Operating Income (Loss)	(20,248)	(27,247)	(23,135)
Nonoperating Revenue (Expense):			
Investment Income	72,831	81,074	120,519
Other Nonoperating Revenue	1,792	1,859	503
Dividend Expense	(6,001)	(4,005)	(2,001)
Total Nonoperating Revenue (Expense)	68,622	78,928	119,021
Change in Net Assets	$ 48,374	$ 51,681	$ 95,886

MSF's Net Earned Premium decreased approximately 13.3% from $173.6M in fiscal year 2011 to $150.5M in fiscal year 2012 as a result of a 20% premium rate reduction to policyholders as a result of HB 334.

MSF's business increased approximately 4.4% from $166.3M of net earned premium in fiscal year 2010 to $173.6M in fiscal year 2011 as a result of increased payroll being reported by policyholders.

Benefits and Claim expenses were 76% of total Operating Expenses in fiscal year 2012, compared to 75% in fiscal year 2011 and 80% in fiscal year 2010. Total operating expenses decreased from $200.9M in fiscal year 2011 to $170.7M in fiscal year 2012. The decrease is mostly the result of a stable LAE rate in the current year. In fiscal year 2011, the LAE rate had increased from 10.8% to 12.4% causing a significant increase in the loss expenses incurred in fiscal year 2011. In fiscal year 2012, the LAE rate applied was 12.9%.

Investment income decreased from $81.1M in fiscal year 2011 to $72.8M in fiscal year 2012 as a result of a reduction of $7.0M in net unrealized gains, a decrease of $1.5M of net realized gains and an increase in bond income in the amount of $500K. Investment income decreased from $120.5M in fiscal year 2010 to $81.1M in fiscal year 2011. The decrease is mostly a result of market fluctuations and less unrealized net gains in fiscal year 2011.

MSF dividends return to employers a portion of premiums paid to MSF. It is a way for MSF to share our strong financial results with those employers who help make it possible by lowering workplace injuries. MSF paid dividends to policyholders of $6.0M in fiscal year 2012, $4.0M in fiscal year 2011 and $2.0M in 2010. The Board of Directors, at its discretion, recommends the amount of dividends to be declared. MSF has declared and paid dividends for thirteen consecutive years.

Montana State Fund
Statement of Net Assets
Montana State Fund is a component unit of the State of Montana

June 30,	2012	2011 (Restated)
ASSETS		
Current Assets		
Cash and Cash Equivalents	$ 26,136,607	$ 19,715,216
Receivables, Net	62,229,980	58,105,262
Securities Lending Collateral	149,464,962	89,189,742
Other Assets	5,383,285	5,536,089
Total Current Assets	243,214,834	172,546,309
Noncurrent Assets		
Investments	1,263,070,316	1,203,148,728
Reinsurance Receivables	44,523,008	36,553,784
Equipment, Net	2,569,015	3,365,080
Land	1,139,460	1,139,460
Buildings, Net	26,835,385	27,368,419
Construction Work in Progress	-	500,000
Intangible Assets	1,807,101	2,346,907
Total Noncurrent Assets	1,339,944,285	1,274,422,378
Total Assets	$ 1,583,159,119	$ 1,446,968,687
LIABILITIES		
Current Liabilities		
Accounts Payable	$ 10,885,437	$ 15,281,660
Estimated Claims Payable	114,004,107	109,287,428
Compensated Absences	1,780,343	1,228,717
Securities Lending Liability	149,464,962	89,189,742
Unearned Premium	42,468,980	37,369,134
Policyholder Deposits	2,590,408	2,775,270
Total Current Liabilities	321,194,237	255,131,951
Noncurrent Liabilities		
Estimated Claims Payable	775,936,467	765,515,456
Reinsurance Funds Withheld	68,972,283	57,887,750
Compensated Absences	897,650	1,469,122
Other Post Employment Benefits	4,225,492	3,404,953
Total Noncurrent Liabilities	850,031,892	828,277,281
Total Liabilities	1,171,226,129	1,083,409,232
NET ASSETS		
Invested in Capital Assets, Net of Related Debt	32,350,962	34,719,868
Unrestricted	379,582,028	328,839,587
Total Net Assets	411,932,990	363,559,454
Total Liabilities and Net Assets	$ 1,583,159,119	$ 1,446,968,687

The notes to the financial statements are an integral part of this statement.

Montana State Fund
Statement of Revenues, Expenses, and Changes in Fund Net Assets
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2012	2011 (Restated)
Net Premiums Earned	$ 150,482,457	$ 173,605,442
Operating Expenses		
Benefits and Claims	129,664,181	150,680,148
Personal Services	25,245,373	24,453,933
Contractual Services	4,210,844	12,804,537
Supplies and Materials	575,923	578,162
Depreciation	1,475,623	1,513,752
Amortization	1,514,338	2,176,315
Rent and Utilities	512,427	521,273
Communications	1,264,377	1,318,869
Travel	152,584	187,737
Repair and Maintenance	1,355,040	1,419,999
Other Operating Expenses	4,759,833	5,197,420
Total Operating Expenses	170,730,543	200,852,145
Operating Income (Loss)	(20,248,086)	(27,246,703)
Nonoperating Revenue(Expenses)		
Investment Income	72,830,911	81,074,233
Securities Lending Income	1,139,151	1,163,869
Securities Lending Expenses	(251,894)	(320,544)
Penalties and Interest	48,767	22,901
Loss on Retirement of Assets	952	14,465
Dividend Expense	(6,001,168)	(4,004,521)
Other Income	12,518	36,539
Payment From State of Montana	842,385	940,981
Total Nonoperating Revenue(Expenses)	68,621,622	78,927,923
Change in Net Assets	48,373,536	51,681,220
Total Net Assets - Beginning (As Restated)	363,559,454	311,878,234
Total Net Assets - Ending	$ 411,932,990	$ 363,559,454

The notes to the financial statements are an integral part of this statement.

Montana State Fund
Statement of Cash Flows
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2012	2011 (Restated)
Cash Flows from Operating Activities		
Receipts for Premiums	150,936,447	175,074,500
Payments to Suppliers for Goods and Services	(13,398,945)	(22,489,901)
Payments to Employees	(24,084,934)	(22,053,134)
Cash Payments for Claims	(114,452,759)	(115,884,349)
Other Operating Receipts	903,668	1,000,419
Net Cash Provided by (Used for) Operating Activities	(96,523)	15,647,535
Cash Flows from Noncapital Financial Activities		
Payment of Dividends to Policyholders	(6,001,168)	(4,004,521)
Net Cash Provided by (Used for) Noncapital Financing Activities	(6,001,168)	(4,004,521)
Cash Flows from Capital and Related Financing Activities		
Acquisition of Fixed Assets	(621,055)	(690,440)
Proceeds from Sale of Fixed Assets	952	14,465
Net Cash Used for Capital and Related Financing Activities	(620,103)	(675,975)
Cash Flows from Investing Activities		
Purchase of Investments	(229,638,613)	(217,505,513)
Proceeds from Sales or Maturities of Investments	199,454,070	154,963,930
Proceeds from Securities Lending Transactions	1,139,151	1,163,869
Payments of Security Lending Costs	(246,810)	(333,129)
Interest and Dividends on Investments	42,431,387	42,310,345
Net Cash Provided by (Used For) Investing Activities	13,139,185	(19,400,498)
Net Increase (Decrease) in Cash and Cash Equivalents	6,421,391	(8,433,459)
Cash and Cash Equivalents - July 1	19,715,216	28,148,675
Cash and Cash Equivalents - June 30	26,136,607	19,715,216

The notes to the financial statements are an integral part of this statement.

Montana State Fund
Statement of Cash Flows
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2012	2011 (Restated)
Reconciliation of Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Change in Net Assets	48,373,536	51,681,220
Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Depreciation	1,475,623	1,513,752
Amortization	1,514,338	2,176,315
Security Lending Costs	251,894	320,544
Security Lending Income	(1,139,151)	(1,163,869)
Income on Investments	(72,830,911)	(81,074,233)
Payments of Dividends to Policyholders	6,001,168	4,004,521
Decrease (Increase) in		
Accounts Receivable	(3,462,239)	6,437,807
Other Assets	151,851	11,107
Increase (Decrease) in		
Accounts Payable	(4,401,306)	(4,278,835)
Due to Primary Government	-	(16,981)
Unearned Premium	5,099,846	(9,685,192)
Property Held in Trust	(184,863)	(469,790)
Funds Withheld	3,115,306	9,163,149
Estimated Claims Payable	15,137,690	36,037,544
OPEB Liability	820,539	843,213
Compensated Absences	(19,846)	147,263
Total Adjustments	(48,470,059)	(36,033,685)
Net Cash Provided by (Used for) Operating Activities	(96,523)	15,647,535

The notes to the financial statements are an integral part of this statement.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2012 and 2011

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. The Board has full power, authority, and jurisdiction in the administration of MSF as fully and completely as the governing body of a private mutual insurance carrier. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the MSF or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the assets held by MSF are subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds and assets held by the Old Fund. Other than the administrative fees paid for the management of the Old Fund claims, no State of Montana General Fund money is used for MSF operations.

Change in Reporting Entity

The assets of the Old Fund were completely liquidated in fiscal year 2011 and it is now fully supported by General Fund resources as required under state law (Section 39-71-2352, MCA). Therefore, the Old Fund is considered to be part of the Primary Government for financial reporting purposes and is not included in the accompanying financial statements.

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Restatement of Prior Year

MSF restated fiscal year 2011 to correct the reinsurance funds withheld asset balance in the Statement of Net Assets and the contingent commission (contractual services expense) in the Statement of Revenues, Expenses, and Changes in Fund Net Assets. MSF was recording the asset based on a per accident year basis for the reinsurance program. The asset should have been recorded based on the aggregate results from a multi-year contract perspective. Since MSF determined the balance on a year by year basis and did not carry a cumulative impact for the multi-year contract periods of 2003-2005 and 2009-2012, the reinsurance funds withheld asset was overstated by $7.0M. FY11 beginning net assets decreased from $316.9M to $311.9M (restated). This is a change of $5.0M directly to equity and a $2.0M adjustment was recorded to contingent commission (contractual services expense).

Basis of Accounting

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for their workers' compensation insurance operations. Under the accrual basis, revenues are recorded in the accounting period earned, if measurable, and expenses are recorded in the period incurred, if measurable.

Cash and Cash Equivalents

Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. MSF participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less with the exception of securities having rate reset dates. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balances as of June 30, 2012 and June 30, 2011 were $21.8M (million) and $14.9M, respectively.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The Montana Board of Investment's (BOI) policy requires that STIP investments have the highest rating in the short-term category by one of any Nationally Recognized Statistical Rating Organizations (NRSRO).

Investments

In addition to STIP investments, the BOI invests in long-term securities. Under the provisions of the state constitution, MSF invested assets are managed by the BOI. Securities are stated at fair value as defined and required by GASB Statement 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized

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using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

The BOI follows the provisions of GASB Statement No. 40 – Deposit and Investment Risk Disclosures. The investment risk disclosures are described in the following paragraphs.

Credit Risk

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation. With the exception of the U.S. government securities, the State Fund fixed income instruments have credit risk as measured by major credit rating services. This risk is that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investments' policy requires MSF fixed income investments, at the time of purchase, to be rated investment grade as defined either by Moody's or by Standard & Poor's (S&P) rating services. The investment policy, revised in February 2011, states "the maximum fixed income credit risk will be limited to 2% of the total securities portfolio in any one name". The U.S. government securities are guaranteed directly or indirectly by the U.S. government. Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. The credit ratings presented in the following table are provided by S&P's rating services. If an S&P rating is not available, a Moody's rating has been used.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. As of June 30, 2012 and 2011, all the fixed income and other equity securities were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank, State Street Bank. The Equity Index investments were purchased in the State of Montana Board of Investments name.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. The MSF Investment Policy requires credit risk to be limited to 2 percent in any one corporate name with "no limitation on U.S. government/agency securities". Investments issued or explicitly guaranteed by the U.S. government are excluded from the concentration of credit risk requirement.

In October 2008, the U.S. government extended the explicit guarantee to certain government agencies such as Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (FHLMC-Freddie Mac). Given the explicit guarantee extension, State Fund had no concentration of credit risk exposure to Fannie Mae and Freddie Mac. However, the State

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Fund reports a June 30, 2012 concentration of credit risk of 5.33% in Federal Farm Credit Bank agency securities.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The MSF policy sets an average duration range of 2-5 years for fixed income securities except in extraordinary circumstances where a shorter duration may be advisable. In accordance with GASB Statement No. 40, the Board has selected the effective duration method to disclose interest rate risk. This method, as provided by our analytics software, is "An option-adjusted measure of a bond's (or portfolio's) sensitivity to changes in interest rates. Duration is defined as the average percentage change in a bond's price for a given change in interest rates. Prices move inversely to interest rates. The effective duration method incorporates the effect of the embedded options for bonds and changes in prepayments for mortgage-backed securities (including pass-throughs, CMOs and ARMs)."

As of June 30, 2012, the State Fund held one $10 million par synthetic Collateralized Debt Obligations (CDO) variable rate position in Aria II, 0.00%, 10/10/2012. A CDO is a security backed by a pool of bonds, loans or other assets. CDOs do not specialize in one type of debt but are often non-mortgage loans or bonds. The MSF portfolio does not hold any structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). REMICs are pass-through vehicles for multiclass mortgage-backed securities. The REMIC securities are based on separate or combined cash flows from principal and interest payments on underlying mortgages.

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, or other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets.

As of June 30, 2012, the MSF portfolio held one variable rate corporate bond with $10 million par. Although the current interest rate is zero, the variable rate is set to float with the six month LIBOR (London Interbank Offered Rate) plus a variable spread on a notional amount percent. As of June 30, 2011, the MSF portfolio held three variable rate corporate bonds with $26 million par. Two of these variable rate securities matured in fiscal year 2012.

MSF investments are categorized below to disclose credit and interest rate risk as of June 30, 2012 and June 30, 2011. Credit risk reflects the bond quality rating, by investment type, as of the June 30 report date. If a bond investment type is unrated, the quality type is indicated by NR (not rated). Interest rate risk is disclosed using effective duration. The credit quality ratings have been calculated excluding cash equivalents.

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Credit Quality Rating and Effective Duration as of June 30, 2012

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	$	682,944,016	A-	3.73
Corporate Bonds (Unrated)		1,125,000	NR	NA
U.S. Government Direct Obligations		172,301,031	AA+	5.39
U.S. Government Agency		264,501,062	AA+	3.88
STIP/SIVs (Unrated)		22,170,659	NR	
Total Fixed Income Investments		1,143,041,768	A+	3.94
Direct Investments				
Equity Index Fund-Domestic		127,308,260		
Equity Index Fund-International		14,531,437		
Total Equity Index Funds		141,839,697		
Total Direct Investments	$	141,839,697		
Total Investments	$	1,284,881,465		

Legal and Credit Risk

As of June 30, 2012 and 2011, the Federal National Mortgage Association and Federal Home Loan Mortgage Corp. remain in conservatorship from September 7, 2008.

On September 15, 2008, Lehman Brothers filed for bankruptcy protection. The State Fund held two positions of Lehman Brothers Holdings, Inc., $5 million par, 0.0%, 05/25/2010 and $4 million par, 5%, 01/14/2011. Lehman Brothers filed for Chapter 11 bankruptcy on September 15, 2008. During fiscal year 2009, the Board wrote down the par value of these bonds. As of June 30, 2011, these securities, due to write downs, reported a book value of 20% of their original par value.

Because Lehman reached an agreement on their bankruptcy, the Board sold the $4 million position in Lehman Brothers Holdings, Inc. 5% rate, January 14, 2011 maturity at a price of $26 on December 6, 2011. Because the bonds were previously written down to a price of $20, this sale generated a gain of $257,840. On April 18, 2012, the Board received a bankruptcy principal payment of $300,344 on the remaining variable rate Lehman Brothers Holdings, Inc. position. The security carries a book value of $699,666 as of June 30, 2012

In August 2011, S&P downgraded the U.S. AAA bond rating to AA+.

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The following table presents the market values of the securities on loan and the total collateral held for fiscal years ended June 30, 2012 and 2011:

	2012	**2011**
Securities on Loan - Market Value	201,687,361	299,574,784
Total Collateral Held	206,240,094	306,415,876

Income earned related to securities on loan for MSF for the fiscal years ended June 30, 2012 and 2011 was $1.1M and $1.2M, respectively. Expenses related to securities on loan for MSF for the fiscal years ended June 30, 2012 and 2011 were $252K (thousand) and $321K, respectively.

MSF is allowed by Montana Constitution to invest in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. The BOI policy for MSF maintains equities in the 8% to 12% range. As of June 30, 2012, equity securities in MSF include $100.0M at cost, increased by $41.8M in market value appreciation. As of June 30, 2011, equity securities in MSF include $99.0M at cost, increased by $38.5M in market value appreciation. Additional investment information can be found in Note 2.

Receivables

At June 30, 2012, MSF had a net receivable balance of $62.2M. The net receivable for billed premium and claim benefits overpayments is $8.3M, which is then reduced by the estimated uncollectible receivables reported as an allowance for doubtful accounts of $2.9M. Other receivables include $40.2M in unbilled premium, $11.9M in investment income due, $313K in retrospective premium and $359K in notes and loans receivable, all of which are short term. Accounts receivable also includes $4.0M at June 30, 2012 for premium that has been earned but unbilled (EBUB).

At June 30, 2011, MSF had a net receivable balance of $58.1M. The net receivable for billed premium and claim benefit overpayments is $6.3M which is then reduced by the estimated uncollectible receivables reported as an allowance for doubtful accounts of $2.7M. Other receivables include $39.0M in unbilled premium, $11.2M in investment income due, $740K in retrospective premium and $201K in notes and loans receivable, all of which are short term. Accounts receivable also includes $3.4M at June 30, 2011 for EBUB.

Reinsurance Receivables

As part of the aggregate stop loss reinsurance program, MSF records a receivable for each contract year's funds withheld amount until the loss performance for that contract year is known. The receivable is increased as interest accrues and decreased with the development of recoverable or in the event of a commutation. The reinsurance receivables were $44.5M at June 30, 2012 and $36.6M (restated) at June 30, 2011.

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Equipment, Accumulated Depreciation and Intangible Assets

Equipment is capitalized if the actual or estimated historical cost exceeds $5K. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF financials and shown net of depreciation.

Other Assets

Other assets include advances, prepaid expenses and deferred acquisition costs. Deferred acquisition costs are amounts incurred during the policy writing process that are recognized ratably over the related policy term.

For the fiscal year ended June 30, 2012, MSF financial statements include $1.1M in land and $26.8M in buildings, net of depreciation. For the fiscal year ended June 30, 2011, MSF financial statements include $1.1M in land and $27.4M in buildings, net of depreciation.

Accounts Payable

Accounts payable is a short term liability account reflecting amounts owed for goods and services received by MSF.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Towers Watson, an external actuarial firm, prepares an actuarial study that provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected central estimates within that range as the estimated claims payable for MSF. For additional disclosure related to the estimated claims payable, refer to Note 4.

Unearned Premium

Unearned premium reflects premium that has been written but not yet earned. The unearned premium was $42.5M and $37.4M at June 30, 2012 and 2011, respectively.

Policyholder Deposits

Policyholder deposits consist of security deposits owed to policyholders that are required to have a deposit policy and secure the policy with cash, letter of credit or certificate of deposit.

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Reinsurance Funds Withheld

Reinsurance funds withheld represents the reinsurance funds held on behalf of the reinsurer, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. Net Assets increased from $363.6M (restated) in FY11 to $411.9M in FY12.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the GASB. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF.

An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; or (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an

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external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company but operates in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

2. Investments

The amortized cost and market value of MSF's fixed maturity and equity securities as of June 30, 2012, and 2011, is as follows:

		Gross Unrealized		
June 30, 2012	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 345,334,682	$ 38,330,810	$ -	$ 383,665,492
Government Mortgage-Backed	49,253,084	3,883,516	-	53,136,600
Corporate Securities Asset-Backed	39,090,242	1,217,741	500,000	39,807,983
Other Corporate Securities	601,548,372	43,089,376	376,715	644,261,033
Other Securities	359,511	-	-	359,511
Equity Securities	100,063,227	41,776,471	-	141,839,698
STIP	21,811,149	-	-	21,811,149
Total	$ 1,157,460,266	$ 128,297,914	$ 876,715	$ 1,284,881,466

		Gross Unrealized		
June 30, 2011	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 365,213,387	$ 27,810,308	$ 91,941	$ 392,931,754
Government Mortgage-Backed	25,304,778	1,928,853	-	27,233,631
Corporate Securities Asset-Backed	38,775,014	1,618,879	2,500,121	37,893,772
Other Corporate Securities	571,993,354	35,479,956	173,137	607,300,173
Other Securities	257,158	-	-	257,158
Equity Securities	99,007,538	38,524,702	-	137,532,240
STIP	14,889,039	-	-	14,889,039
Total	$ 1,115,440,268	$ 105,362,698	$ 2,765,199	$ 1,218,037,767

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2012 and 2011 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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June 30, 2012

	Amortized Cost	Market Value
Due one year or less	$ 115,204,259	$ 115,862,339
Due after one year through five years	520,577,272	561,457,310
Due after five years through ten years	398,481,913	440,864,563
Due after ten years	23,133,595	24,857,556
Equity Securities	100,063,227	141,839,697
Total	$ 1,157,460,266	$ 1,284,881,465

June 30, 2011

	Amortized Cost	Market Value
Due one year or less	$ 115,606,564	$ 117,099,694
Due after one year through five years	503,464,929	529,533,293
Due after five years through ten years	358,522,151	392,569,766
Due after ten years	38,839,086	41,302,774
Equity Securities	99,007,538	137,532,240
Total	$ 1,115,440,268	$ 1,218,037,767

During the fiscal year ending June 30, 2012, MSF realized gross gains from sales of securities of $4.9M and gross realized losses of ($30K). During the fiscal year ending June 30, 2011, MSF realized gross gains from sales of securities of $6.5M and gross realized losses of ($55K).

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2012, investment income for MSF was $72.8M including an unrealized gain on investments in the amount of $24.8M. Investment income for fiscal year 2011 was $81.1M including an unrealized gain on investments of $31.8M.

3. Reinsurance

For the fiscal years ended June 30, 2012 and 2011, MSF ceded premiums to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against individual occurrences over stipulated amounts and an aggregate stop loss contract which protects MSF against the potential that aggregate losses will exceed expected levels expressed as a percentage of premium.

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The excess of loss contract provides coverage up to $100 million in which MSF retains the first $5 million for the first layer of reinsurance coverage. The excess of loss protection applies to an individual occurrence with the maximum of $5 million on any one life. The excess of loss contracts coverage for fiscal years 2012 and 2011 is as follows:

Contract Period	Reinsurance Coverage
2012	Workers' compensation accidents of up to $5M in excess of $5M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $20M in excess of $10M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $70M in excess of $30M, maximum of $5M per any one claimant.
2011	Workers' compensation accidents of up to $5M in excess of $5M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $20M in excess of $10M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $70M in excess of $30M, maximum of $5M per any one claimant.

The term of the current aggregate stop loss contract is July 1, 2008 through June 30, 2012. The contract provides coverage based on MSF’s premium levels, not to exceed 15% of the subject net earned premium. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $11.5M and $11.3M in fiscal years 2012 and 2011, respectively. The aggregate stop loss contract requires that MSF maintain a funds-withheld liability account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The total funds withheld account at June 30, 2012 is $69.0M for contracts in place from July 1, 2002 to June 30, 2012. The funds withheld account at June 30, 2011 was $57.9M for contracts in place from July 1, 2002 to June 30, 2011. Interest must be accrued on the funds withheld account which resulted in accrued interest of $3.5M for fiscal year 2012 and $2.9M for fiscal year 2011.

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Estimated claim reserves were reduced by $12.8M and $8.0M for fiscal years 2012 and 2011 respectively for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excess of loss reinsurance contract. In fiscal year 2012 the estimated claim reserves were reduced by an additional $24.3M and in fiscal year 2011 an additional $21.2M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the aggregate stop loss contract.

As part of the aggregate stop loss reinsurance program, MSF records a reinsurance receivable for each contract year's funds withheld amount until the loss performance for that contract year is known. The receivable is increased as interest accrues and decreased with the development of recoverable or in the event of a commutation. The reinsurance receivables were $44.5M at June 30, 2012 and $36.6M (restated) at June 30, 2011.

MSF also has assumed reinsurance relationships with Zurich American Insurance Company, Argonaut Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk related to Montana domiciled businesses with operations in other states, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2012 and 2011 is $1.5M and $1.8M, respectively. The incurred losses from OSC benefits were $859K and $610K for fiscal years 2012 and 2011, respectively. The assumed liability for OSC claims is $3.7M and $4.8M for fiscal years 2012 and 2011, respectively.

4. Risk Management

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF financials. At June 30, 2012, approximately 24,686 active policies were insured by MSF. At June 30, 2011, approximately 24,780 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the guaranteed market insurer for employers since workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. Towers Watson, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2012 and 2011. Because actual claim costs depend on such complex factors such as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and

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social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Towers Watson provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected a central estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2012 and 2011. The MSF estimated unpaid claims and claims adjustment expenses payable is presented at face value, net of estimated reinsurance recoverable, at $889.9M and $874.8M, as of June 30, 2012 and 2011, respectively. The estimated claims payable increased $15.1M from 2011 to 2012, which is primarily due to additional development of approximately $2.0M on prior year claims and an increase of $12.4M for additional reserve strengthening. The increase for the reserve strengthening is due to the uncertainty from anticipated savings resulting from House Bill 334 and the consequence of the 20% premium reduction that was done in fiscal year 2011.

MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate.

State law (Section 39-71-2311, MCA) requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2012 and 2011 are $4.1M and $4.2M, respectively.

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Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF for the past two years, net of estimated reinsurance recoverable. The information presented has not been discounted.

	2012	2011
Unpaid claims and claim adjustment expenses at beginning of year	$ 874,802,884	$ 838,765,340
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	125,474,449	143,337,473
Increase(Decrease) in provision for events in prior years	4,189,732	7,323,174
Total incurred claims and claim adjustment expenses	129,664,181	150,660,647
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	(24,729,053)	(27,923,613)
Claims and claim adjustment expenses attributable to insured events of PY	(89,797,438)	(86,699,490)
Total payment	(114,526,491)	(114,623,103)
Total unpaid claims and claim adjustment expenses at end of the year	$ 889,940,574	$ 874,802,884

5. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M. MSF allocated $842K and $941K in administration costs to the Old Fund in fiscal years 2012 and 2011, respectively. Beginning in June 2011, the State of Montana General Fund began making transfers to cover the cost of administering the Old Fund claims. These transfers are recorded as non-operating revenue as a payment from the State of Montana.

6. MSF Distributions

During the fiscal year ended June 30, 2012, the MSF Board of Directors authorized a dividend to policyholders. MSF paid dividends to eligible policyholders in the amount of $6.0M for the policy year 2009. The MSF Board of Directors authorized and MSF paid a dividend of $4.0M in fiscal year 2011 for policy year 2008.

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7. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program, (Traditional Plan) and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers union represented employees who have elected to remain in the plan. These employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to non-exempt employees in the Traditional Plan. MSF Personal Leave Program covers all non-union employees, union employees hired before July 26, 2006 who have elected to adopt the plan, and all employees hired after July 25, 2007. Employees in the Personal Leave Program accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

The total compensated absences liability for MSF is $2.7M for both years ending at June 30, 2012 and 2011.

8. Retirement Plans

MSF and its employees contribute to the Public Employees' Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF employees hired prior to July 1, 2011 are required to contribute 6.9% of annual compensation in fiscal years 2012 and 2011. Employee's hired on or after July 1, 2011 are required to contribute 7.9%. The employer (MSF) is required to contribute 7.17% of annual compensation in fiscal years 2012 and 2011 regardless of the hire date of the employee. MSF's contributions amounted to $1.4M and $1.3M for fiscal years 2012 and 2011, respectively. MSF and its employees paid one hundred percent of statutorily required contributions to PERS and there is no unpaid liability as of June 30, 2012. The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive*

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Annual Financial Report for the fiscal year-end. This information is available from PERB at 100 North Park Avenue, Suite 220, P.O. Box 200131, Helena, MT 59620-0131, (406) 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

GASB recently issued standards 67 and 68, Accounting and Financial Reporting for Pensions. These standards will require MSF to record pension accounting entries as well as financial statement disclosures. The requirements of these Standards are effective for financial statements for fiscal years beginning after June 15, 2014. The State of Montana is in the process of determining the effect of the change in accounting and obtaining an estimate of the amount of the unfunded liability, however, an estimate of the amount has not been available. Management believes the amount attributable to MSF will be significant, once the State of Montana completes its valuation.

9. Leases and Commitments

MSF leases office facilities outside of Helena under various operating leases that expire through December 2015.

MSF leases 350 parking spaces in a parking garage that was built by the City of Helena adjacent to the MSF facility that expires June 30, 2040. The cost of the parking spaces will be the same monthly rate as equivalent parking passes sold by the city. The parking facility opened in conjunction with the move to the new building in June 2010. The annual subsequent parking cost is estimated to be $249K with potential to change based on parking rates assigned by Helena Parking Commission.

Rental expenses for FY12 of $314K include $251K for the parking garage lease, $51K for office facility leases and $12K for minor office equipment. Rental expenses for FY11 of $304K includes $233K for the parking garage lease, $53K for office facility leases and $18K office equipment.

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The future minimum rental payments for office and parking space are as follows:

Fiscal Year	Amount
2013	$ 297,252
2014	288,294
2015	263,853
2016	263,100
2017	250,350
Thereafter	5,699,400
	$ 7,062,249

10. Other Post-Employment Benefits (OPEB)

Beginning with the fiscal year ending June 30, 2008, the State of Montana implemented Governmental Accounting Standards Board (GASB) Statement 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions. This statement requires the disclosure of employer liability for retiree medical subsidies and other post-employment benefits. The OPEB liability at June 30, 2012 and 2011 was $4.2M and $3.4M respectively.

Post-employment Healthcare Plan Description:

MSF employees and dependents are eligible to receive health care through the State Group Benefits Plan administered by the Montana Department of Administration. In accordance with section 2-18-704, MCA, the State provides optional post-employment medical, vision and dental health care benefits to the following employees and dependents who elect to continue coverage and pay administratively established premiums: (1) employees and dependents who retire under applicable retirement provisions and (2) surviving dependents of deceased employees. For GASB 45 reporting, the State Group Benefits Plan is considered an agent multiple-employer plan and MSF is considered to be a separate employer participating in the plan.

In addition to the employee benefits described in Note 9 Retirement Plans, the following post-employment benefits are provided. Montana Department of Administration established retiree medical premiums vary between $285 and $982 per month depending on the medical plan selected, family coverage, and Medicare eligibility. Retirees pay 100 percent of the premiums for medical, dental, and vision. Administratively established monthly dental premiums vary between $34.90 and $59.36; monthly vision premiums vary between $7.64 and $22.26; both premiums vary depending on the coverage selected. Basic life insurance in the amount of $14,000 is provided until age 65 at a cost of $1.90 per month. The State Benefit Plans reimburse

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all validated medical claims net of member obligations (annual deductibles and coinsurance of the members' selected medical plan). Dental claims are reimbursed at 50% to 100% of the allowable charges, depending on the services provided. The State acts as secondary payer for retired Medicare-eligible claimants.

Benefits Not Included in the Actuarial Valuation:

The dental and vision benefits are fully-insured and retirees pay 100 percent of the cost for both dental and vision, therefore, no liability for these benefits is calculated in the actuarial valuation. Continuation of the life insurance benefit is not available as an employer-provided group insurance benefit for retirees, therefore, no liability for life insurance is calculated in this valuation.

Funding Policy:

The following estimates were prepared based on an actuarial evaluation prepared as of the year ending December 31, 2011 for the Department of Administration and the resulting State of Montana Actuarial Valuation of Other Post-Employment Benefits Plan (plan) contains the MSF data and is available through:

Montana Department of Administration
State Accounting Division
Room 255, Mitchell Bldg.
125 N Roberts St
PO Box 200102
Helena, MT 59620-0102

GASB 45 requires the plan's participants, including the MSF, to report each year the annual required contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year of retiree health care costs and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years. The 2011 ARC is calculated for all the State plan's participants and then individually allocated to individual participants. The MSF 2012 allocated portion of the ARC is estimated at $821K and is based on the plan's current ARC rate of 6.32% percent of participants' annual covered payroll. The MSF 2012 ARC is equal to an annual amount required each year to fully fund the liability over thirty years.

Actuarial Methods and Assumptions:

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs

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between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents information that shows the actuarial value of plan assets and liabilities. In the January 1, 2011, actuarial valuation date, the projected unit credit funding method is used. The actuarial assumptions did not include an investment rate of return since no assets meet the definition of plan assets under GASB 43 or 45. Annual healthcare cost trend rates of 10 percent were used for both medical and prescription claims. The unfunded actuarial accrued liability is amortized following a 30-year level percent of pay amortization on an open basis, using a 4.25 percent discount rate and a 2.50 percent payroll growth rate assumption.

The State finances claims on a pay-as-you-go basis and does not advance-fund the OPEB liability. While this liability is disclosed for financial statement purposes it does not represent a legal liability of the State of Montana or MSF. Therefore, the following cost information shows no value for Plan Assets made by MSF.

Annual Other Post Employment Benefits (OPEB) Cost:

MSF's allocated annual OPEB cost (expense) was $821K and $812K for the years ending June 30, 2012 and 2011, respectively.

The MSF annual OPEB cost, the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for 2012 and prior are as follows:

Fiscal Year Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
6/30/2008	858,215	0.00%	858,215
6/30/2009	894,689	0.00%	1,752,904
6/30/2010	808,837	0.00%	2,561,741
6/30/2011	843,212	0.00%	3,404,953
6/30/2012	820,539	0.00%	4,225,492

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Funded Status and Funding Progress:

The most recent actuarial valuation available that was completed by the State of Montana was as of January 1, 2011 for the year ending December 31, 2011. This actuarial evaluation is completed every two years with the next valuation to be completed as of January 1, 2013 for the year ending December 31, 2013.

The MSF allocation of the plan as of the year ending December 31, 2012 was as follows:

Actuarial Accrued Liability (AAL)	$6,355,058
Actuarial Value of Plan Assets	$0
Unfunded Actuarial Accrued Liability (UAAL)	$6,355,058
Funded Ratio (Actuarial Value of Plan Assets/AAL)	$0
Covered Payroll (Active Plan Members)	$19,544,196
UAAL as a Percentage of Covered Payroll	32.52%

11. Contingencies

Victory Insurance Company, Inc. v. Montana State Fund et al. Victory filed its Amended Complaint in this action on March 29, 2011, in which it asserts various tort claims against Montana State Fund. No specific amounts of damages were stated in the complaint. Pre-trial discovery is ongoing at this time. The actual potential cost impact to the State Fund is not known at this time. Montana State Fund does not have sufficient information to determine potential liability or cost impact.

Lester Roberts v. G & C Industries. Montana State Fund is defending this litigation against a State Fund policyholder that may be covered by the employer's liability coverage of the State Fund's insurance policy. State Fund has an accepted workers' compensation claim based on the injury incurred in this case. The exclusive remedy provisions of MCA Section 39-71-411 should bar this type of tort claim against the policy holder. However, if the plaintiffs are successful in convincing the court that MCA Section 39-71-411 does not provide a defense, then the employer-policyholder may be legally responsible for causing the injuries to its employee. It is reasonably possible that Montana State Fund may be called upon to indemnify the employer-policyholder, up to the policy limits of $1,000,000. The potential cost impact to the State Fund is not known at this time.

Montana State Fund also is involved in a great deal of litigation in the areas of workers' compensation and disputes with policyholders. These are of a generally routine nature and there are no known matters at this time that will have a large and widespread financial impact.

12. Subsequent Events

On October 1, 2012, the Board of Investments received a bankruptcy principal payment of $191,035 on the remaining variable rate Lehman Brothers Holdings, Inc. position.

REQUIRED SUPPLEMENTARY INFORMATION

Other Post-Employment Benefits (Financial Statement Note 10)

As of June 30, 2012, the most recent actuarial valuation available that was completed by the State of Montana was as of January 1, 2011 for the year ending December 31, 2011. This actuarial evaluation is completed every two years with the next valuation to be completed as of January 1, 2013 for the year ending December 31, 2013.

The State of Montana finances claims on a pay-as-you-go basis and does not advance fund the OPEB liability. Therefore, the funded ratio remains at 0% at June 30, 2012.

SCHEDULE OF FUNDING PROGRESS

Date	Actuarial Value of Assets (A)	Actuarial Accrued Liability (AAL) (B)	Unfunded AAL (UAAL) (B-A)	Funded Ratio (A/B)	Covered Payroll (C)	UAAL as a Percentage of Covered Payroll (B-A)/C)
1/1/2007	$0	$8,079,405	$8,079,405	0.00%	$16,805,676	48.08%
1/1/2009	$0	$6,985,326	$6,985,326	0.00%	$16,766,753	41.66%
1/1/2011	$0	$6,355,058	$6,355,058	0.00%	$19,544,196	32.52%

Risk Management

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 2003 through 2012. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

Risk Management Trend Information

(In Thousands)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1. Premiums and Investment Revenue										
Earned	166,477	175,586	235,620	258,165	296,703	279,758	245,234	205,916	197,327	162,900
Ceded	5,654	6,563	6,788	13,618	14,856	14,676	13,702	13,224	11,286	11,501
Net Earned	160,823	169,023	228,832	244,548	281,847	265,082	231,532	192,692	186,040	151,400
2. Unallocated expenses including overhead	31,548	37,569	39,078	40,548	41,947	47,778	49,215	44,188	57,282	49,557
3. Estimated losses and expenses, end of accident year										
Incurred	110,153	120,705	134,290	155,057	170,652	177,100	159,229	137,507	142,989	118,066
Ceded	-	-	-	-	-	-	-	-	9,769	1,099
Net Incurred	110,153	120,705	134,290	155,057	170,652	177,100	159,229	137,507	133,220	116,967
4. Net paid (cumulative) as of:										
End of policy year	22,982	26,123	25,721	30,977	32,708	31,002	29,009	25,475	27,902	24,729
One year later	48,861	50,888	57,239	66,063	67,928	67,034	60,009	52,701	56,502	
Two years later	63,773	66,140	72,229	84,014	85,646	86,268	74,132	66,235		
Three years later	72,957	74,697	82,647	94,091	98,427	95,612	83,737			
Four years later	79,060	80,233	88,236	100,189	104,967	103,337				
Five years later	84,340	83,788	93,682	105,815	109,569					
Six years later	88,645	86,707	96,539	109,993						
Seven years later	89,482	89,038	98,621							
Eight years later	92,167	91,975								
Nine years later	94,763									
5. Re-estimated ceded losses and expenses	8,600	2,267	-	-	-	-	-	-	12,323	1,099
6. Re-Estimated net incurred losses and expense:										
End of policy year	110,153	120,705	134,290	155,057	170,652	177,100	159,229	137,507	133,220	116,967
One year later	110,532	112,609	136,235	157,711	171,783	174,279	152,886	139,554	134,175	
Two years later	112,443	124,413	138,447	163,433	170,786	173,808	151,738	135,833		
Three years later	117,245	127,827	144,484	164,358	172,038	172,888	151,303			
Four years later	115,414	129,051	143,820	165,313	171,987	172,570				
Five years later	119,976	127,702	145,839	164,613	170,997					
Six years later	121,686	127,054	145,031	164,248						
Seven years later	120,020	126,979	142,443							
Eight years later	120,296	126,781								
Nine years later	120,960									
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	10,807	6,075	8,153	9,191	345	(4,529)	(7,926)	(1,673)	954	-

Montana State Fund

State Fund Response

MONTANA STATEFUND

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November 30, 2012

Ms. Tori Hunthausen
Legislative Audit Division
Room 160, State Capitol
Helena, MT 59620-1705

Dear Ms. Hunthausen:

Montana State Fund (MSF) expresses our appreciation to the Legislative Audit Division for the financial-compliance audit of our financial statements.

MSF concurs with the audit recommendation to record the current and long-term estimated claims liabilities in SABHRS prior to the fiscal year-end closing period.

MSF records the total estimated claim liability in one account before the SABHRS year-end close, which typically occurs the third week in July. However, MSF did not differentiate the current portion from the long-term portion of these liabilities prior to SABHRS closing. MSF's independent consulting actuary's estimates of ultimate losses are available later in September which provide the basis for establishing the current portion of the liabilities. Once the MSF Board of Directors approves the loss reserves, adjusting entries are processed to recognize the current and non-current portions of the claim liability for proper presentation in the financial statements. The financial statements contained in this report reflect these adjustments approved by the Board.

MSF submits the following as our Corrective Action Plan: Effective for fiscal year 2013, MSF will estimate and record an additional entry to recognize both the current and long-term portions of the total estimated claims liability in SABHRS prior to the year-end close. Adjusting entries will be made to the MSF financial statements in September to reflect the loss estimates approved by the MSF Board of Directors as current and long term estimated claims liabilities.

Thank you for your continued assistance, and we are pleased to once again have an unqualified opinion on our financial statements.

Sincerely,

Laurence A. Hubbard
President/CEO